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'Real effects of financial reporting and disclosure on innovation'– a practitioner view

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The real effects of reporting is a key issue when setting accounting standards, the job I have done for ten years, and an increasing focus for people evaluating those standards, including the European Financial Reporting Advisory Group (EFRAG) and others doing effects analysis. It is also good to see a focus in an academic paper on how reporting might change. Simpson and Tamayo (2020) discuss the work of the International Accounting Standards Board (IASB) on management commentary and non-GAAP (Generally Accepted Accounting Principles) measures, which I will come back to shortly.

I think the sign of a good paper is to get people to think, and it has certainly had that effect on me. The first thing that came to my mind was perhaps a bit surprising. It made me think of a good friend of mine. He's called Justin. I won't tell you his second name or too much about him, but he is an innovator. He is sitting in some Cambridge science park right now and he is innovating in green energy and green technology.

I have never done innovation, although I am very interested in technology, as I am sure many of you here are. Justin is very much at the sharp end, so I thought I would go and talk to him about financial reporting and innovation. He runs a small private company. He has done innovation in the past and is a successful entrepreneur, although his current project is a long way from reaching the public domain. I was interested that Simpson and Tamayo (2020) differentiate between private companies and public companies in terms of their structure and how reporting might influence things. It is obviously very much a private company focus from Justin's perspective. I will broaden my discussion to public companies in a second.

I asked him about how he thought financial reporting affects his innovation. He initially gave me a blank look because I don't think he understood the words 'financial reporting'; he was not really sure what I was referring to. I then said 'financial statements' and he still gave me a blank look; so I finally said, 'Well, it's your accounts.' 'Ah, yes, I just get my accountant to do those. I

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never look at them.' Of course, he is not really interested accounting; he is interested in technology and developing his idea.

However, Justin is more engaged in financial reporting than perhaps he realises. Firstly, he knows to the penny how much he has spent so far on his project and how much more money he has got left in the kitty to spend in the future. He also has a number of private equity backers, who he meets on a very regular basis. They are very interested in how he is getting on and the progress of his project. Therefore, he provides them with both written and verbal communication, in quite a lot of detail, about his progress. Without that, he would not have raised the finance in the first place.

His private equity backers want to know: How much has he spent? Does he have the right people to complete the development? Will his innovation work? Is somebody else going to beat him to it? Is it going to be commercially viable?

He is doing much more financial reporting than perhaps he would imagine. In a sense, I suppose he is almost doing integrated reporting, but he just does not realise that it is integrated reporting.

What is the real effect of financial reporting on Justin's innovation? Well, it is entirely positive. Without reporting on what he is doing, he would never have got the backing from these private equity backers in order to pursue his passion of inventing stuff related to green energy. Good and transparent financial reporting is, for him, purely a positive thing. The secrecy and the patents are simply avoiding the negative aspects that Simpson and Tamayo (2020) discuss.

From his perspective, the actual financial statements are not really relevant. He could not care less whether what he is spending is capitalised as an asset or as expense. He could not care less about his income statement. The financial statements just say nothing relevant to his private equity backers. Other than the cash balance and how much money there is left and how far he is through his project, the financial statements are really not important. The whole idea of volatility, asset recognition, and all the things that we are concerned about when it comes to public company reporting are just not relevant.

How does this translate into larger organisations? Simpson and Tamayo (2020) talk about a lot of innovation taking place in private companies and the exploitation taking place in public companies. Nevertheless, much innovation has to be done by larger companies simply because of the resources that are required. When you translate it into larger companies there are problems of spill-over effects, compensation, management myopia and short-termism, plus all the other things mentioned in the paper. These become much more of a challenge in that situation. Questions of disclosure, where the disclosure should be and is it mandatory, is it audited, questions of asset recognition, do we capitalise Research & Development (R&D), do we expense it, what about the volatility issue, what about impairment, how should we measure, should it be cost or fair value – all of these things become much more important when we scale up to these public companies.

Simpson and Tamayo (2020) suggest that innovation is a key driver of firm value. It is a driver of survival, and I absolutely agree that when investors are looking at companies, innovation and the product pipeline, are key considerations. In order for them to make those decisions they have to have information, they have to have some transparency.

The section of Simpson and Tamayo's paper I particularly liked was about the real effects of reporting on innovation, and there are a number of things which I was struck by. It says at one point 'An implicit assumption in these studies is that the market is not fully efficient since it suffers from short-termism and applies an excessive discount rate to long-term projects.' Well, if that is true, then that is a bad outcome as far as reporting is concerned. We need to have reporting that avoids that situation.

The paper mentions that 'Current R&D accounting rules are likely to exacerbate investment-related managerial myopia.' That is another factor that is a bad aspect of reporting. We need to sort that out as well.

The problems of accounting for innovation and R&D, are very different from other areas in accounting. Invest in a new hotel that comes on-line quickly, and you can quickly see the results of that through accruals accounting. However, with innovation payoffs are often many years down the road given time lag between investing and getting the results. Some have said that perhaps we should be using fair value as a way of resolving this. I am not sure that is the right approach.

The conclusion of the paper discusses some possible current developments in accounting, and I mentioned the IASB's work on performance reporting and management commentary. I would like to see that developed further. I thought maybe there was some room for additional ideas. I think there needs to be more work done on intangible assets. I would love to see the IASB take on a project related to intangibles. We have a board member here listening, so I hope she takes my comments on board. I think there is no real reason why we should have different accounting for tangible and intangible fixed assets. I would like to see IAS (International Accounting Standard) 16 and 38 replaced by a single standard. I think the recognition of measurement criteria should be the same.

It is great to see work on management commentary. I would like to see more mandated disclosures related to innovation and intangibles and not just within a voluntary management commentary-type framework. Investors have all sorts of challenges in this area because of the different recognition for intangibles arising in business combinations and through organic development. I would like to see more work on that. I am not saying that the accounting should be the same, but I think there should be at least some disclosures to mitigate the problems.

Finally, I would like to see what might perhaps be called a statement of unrecognised intangibles. I think intangibles arising from innovation are so important that I would like to elevate them to a primary financial statement. You know, we have never had a new primary financial statement for years. Perhaps now is the time to have one, a statement of intangibles and innovation.

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Reference

Simpson, A. and Tamayo, A., 2020. Real effects of financial reporting and disclosure on innovation. *Accounting and Business Research*, 50 (5), 401–421.